Office of Chief Counsel
Internal Revenue Service
memorandum
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date:

to: Jerrold Karwhite, Team Case Leader, Appeals LMSB Area 4
Fred Ferrarin, Team Manager, LMSB Natural Resources Team 1432

from: ROBERT H. SCHORMAN, JR.
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subject: **Evaluation of Litigation Hazards re Contingent Liability Shelter [redacted]**
Tax Years [redacted] & [redacted]

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INTRODUCTION

The Service has determined that the taxpayer participated in a contingent liability tax shelter as described in Notice 2001-17 during the taxable years [redacted] and [redacted]. The Service proposes to disallow the capital loss claimed by the taxpayer which was generated by this shelter transaction in [redacted]. This memorandum discusses the hazards of litigating this issue based on the available evidence for purposes of evaluating the taxpayer's global settlement offer. [redacted] has proposed a settlement of all issues in the case except any partnership issues. The proposed settlement would encompass income tax and employment tax issues for the years [redacted], [redacted] and [redacted] regarding [redacted] and income tax issues regarding [redacted] for the same years.

The terms of the proposed settlement include disallowance of the long term capital loss of $[redacted] arising from the contingent liability shelter in [redacted]. [redacted] would be allowed to deduct the [redacted] remediation liabilities as if no assumption had taken place and the government would not assess any penalties against [redacted] with respect to the contingent liability shelter. [redacted] will agree to all proposed adjustments as of [redacted]. The government will not issue any further proposed adjustments (except any resulting from partnership examinations). Procedures will be developed to allow any "rollforward" adjustments resulting from settlements from any years prior to [redacted] to be included in an amended return or revised RAR.

Based upon our evaluation of the litigation hazards of the contingent liability shelter issue as set forth herein, we believe that the proposed settlement is fair to the government.

FACTUAL SUMMARY

On its Form 1120 Consolidated U.S. Corporation Income Tax Return for [redacted], [redacted] and several affiliates reported that they had made section 351 transfers to a controlled corporation, [redacted]. The affiliated transferors included [redacted], [redacted] and [redacted]. [redacted], an insurer and unrelated corporation, was an additional transferor in the section 351 exchange. We do not know the details of [redacted]'s participation in the formation of [redacted]. After the transfer, [redacted] owned [redacted]% of the voting stock of [redacted] and [redacted] owned [redacted]%.

The assets transferred by [redacted] and its affiliates included [redacted] and other accounts receivable. The stated tax basis of the assets transferred by [redacted] and its affiliates was $[redacted].

[redacted] assumed contingent [redacted] liabilities of [redacted] of approximately $[redacted] as part of the transaction. The liabilities represented the estimated cost of [redacted] assessments and [redacted]. It also assumed accounts payable in the amount of $[redacted] from [redacted].

In its "Statement regarding Transfer of Property to a Controlled Entity" attached to its [redacted] federal tax return, [redacted] offered the following explanation for the assumption of the [redacted] liabilities by [redacted]:

[redacted]

As part of the section 351 exchange, [redacted] issued [redacted] shares of common stock to [redacted], [redacted] shares of common stock to [redacted], [redacted] shares of common stock to [redacted] and [redacted] shares of Series B preferred stock with a stated total fair market value of $[redacted] to [redacted]. The total fair market value of all the stock received by [redacted] and its affiliates was reported as $[redacted].

In [redacted], [redacted] sold [redacted] shares of Series B preferred stock of [redacted] to several "accredited" investors, including [redacted], and claimed a long term capital loss of $[redacted] on its [redacted] tax return from the preferred stock sale. The loss was used to partially offset a long term capital gain of $[redacted] resulting from the settlement of [redacted]% exchangeable notes.

[redacted] transferred assets with a tax basis of $[redacted] to [redacted] on [redacted]. [redacted] received Series B preferred stock with a fair market value of $[redacted]. [redacted] assumed contingent [redacted] liabilities of [redacted] of approximately $[redacted]. Apparently, [redacted] determined the [redacted] stock had a basis equal to the basis of the assets transferred to [redacted], unreduced by the amount of contingent liabilities assumed by [redacted]. Assuming [redacted] sold the stock for its fair market value of $[redacted] one arrives at a loss of $[redacted] which is slightly less than [redacted]s claimed loss of $[redacted]. The difference could be due to the costs of sale.

The transaction is purported to qualify as an exchange under section 351, and the basis of the transferee stock received is purported to be equal to the basis of the transferred asset, unreduced by the liability assumed by the transferee corporation. See sections 358(d)(2), 357(c)(3). Although liabilities assumed by a transferee corporation in a section 351 exchange ordinarily are treated as money received by the transferor for purposes of section 358, and reduce basis in the transferee stock accordingly, presumably the taxpayer is relying on section 357(c)(3)(A) and the exception under section 358(d)(2) as grounds for not reducing the basis of the stock received in the purported exchange.[1]

DISCUSSION

In Notice 2001-17, 2001-09 I.R.B. 1 (January 18, 2001), the Service announced that it would disallow losses generated by contingent liability shelters. The Service described two variants of the shelter, one involving corporations that do not file a consolidated return and another involving members of an affiliated group that has elected to file a consolidated return. The [redacted] shelter involves a third party transferor as well as members of the [redacted] consolidated group and thus does not solely involve the [redacted] affiliated group. Notice 2001-17 outlines seven grounds to disallow contingent liability tax shelter generated losses, each of which are discussed herein.

Lack of Business Purpose for Section 351 Exchange

The first argument set forth in Notice 2001-17 is that the purported section 351 exchange lacks sufficient business purpose to qualify as a section 351 exchange. The business purpose doctrine applies to section 351 exchanges. In Caruth v. United States, 688 F. Supp. 1129, 1138-41 (N.D. Tex. 1987), aff'd, 865 F.2d 644 (5th Cir. 1989), the District Court, in a case of first impression, held that there must be a business purpose for a transaction under section 351. See also Rev. Rul. 55-36, 1955-1 C.B. 340. The business purpose offered by the taxpayer, if genuine, would probably be sufficient to meet this requirement, thus making this argument inapplicable. Whether the taxpayer has a sufficient business purpose for the section 351 transaction is a question of fact. Caruth, supra, at 1141. At present, there is insufficient factual development to challenge the taxpayer's proffered business purpose. This is not a strong argument for

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[1]This result would not be reached under current law. See section 358(h).

the Service and there are litigation hazards in factual development.

The facts of [redacted] may fit within the scope of Rev. Rul. 95-74, 1995-2 C.B. 36. Rev. Rul. 95-74 held that a corporate transferee could claim deductions accruing upon payment of assumed liabilities where an entire business and its associated liabilities were transferred in a section 351 exchange. Notice 2001-17 states that Rev. Rul. 95-74 does not apply to contingent liability shelters because the ruling dealt with liabilities assumed by a transferee corporation that received substantially all the assets associated with the operation of a manufacturing business. It is the government's position that Rev. Rul. 95-74 only applies if there is a transfer of a trade or business and, at the time of the section 351 exchange, the taxpayer had no plan to dispose of the stock received. CCDM Notice CC-2001-033a, June 28, 2001. Although the transferors in [redacted] did not transfer the assets of one business to [redacted], they could argue that they transferred the assets necessary to form one business. Thus, there would be a litigation hazard that a court could find the [redacted] transaction is governed by Rev. Rul. 95-74.

It is difficult to evaluate the government's remaining proposed arguments in Notice 2001-17 without further factual development, but some discussion of the legal underpinnings of those arguments seems warranted.

The Transfer is in Substance an Agency Arrangement or Payment for Assumption of a Liability

The first of the five remaining arguments outlined in Notice 2001-17 is that the transfer of the asset to the transferee corporation is not, in substance, a transfer of property in exchange for stock within the meaning of section 351, but instead is either an agency arrangement for the transferor or simply a payment to the transferee for its assumption of a liability. This is a substance over form argument. No authority is cited in Notice 2001-17 for this argument.

There is legal precedent for treating a corporation as the agent of its shareholders. In C.I.R. v. Bollinger, 485 U.S. 340 (1988), the Supreme Court found that corporations used to obtain financing for apartment complexes were agents of the partnerships that owned and operated the apartments. In reaching this result, the Court relied on six factors set forth in National Carbide Corp. v. Commissioner, 336 U.S. 422 (1949):

"'[1] Whether the corporation operates in the name

> and for the account of the principal, [2] binds the principal by its actions, [3] transmits money received to the principal, and [4] whether receipt of income is attributable to the services of employees of the principal and to assets belonging to the principal are some of the relevant considerations in determining whether a true agency exists. [5] If the corporation is a true agent, its relations with its principal must not be dependent upon the fact that it is owned by the principal, if such is the case. [6] Its business purpose must be carrying on of the normal duties of an agent.'" Bollinger, supra, at 346-347.

Presumably, the Service would argue that the above listed factors had been met to support an agency argument. The strength of this argument would depend on factual development. Usually the Service argues against the existence of an agency relationship in the corporate context. The viability of the payment for assumption of liabilities argument would depend on whether there was a strong factual basis to support it. There would be hazards inherent in bringing such novel legal arguments before a court.

The Purported Loss Should be Disallowed Under Section 269(a)

The second remaining argument outlined in Notice 2001-17 is that the purported section 351 exchange constitutes an acquisition of control of the transferee corporation for the principal purpose of tax avoidance within the meaning of section 269(a) and thus the purported loss should be disallowed under section 269(a).

In Barr, 780-2nd T.M., Net Operating Losses and Other Tax Attributes--Sections 381, 382, 383, 384, and 269 (2000), the author notes:

> "Section 269 was the first legislative attempt to police the growing market for loss corporations. Congress gave this weapon to the IRS in 1943 for use against 'trafficking in corporations with operating loss carryovers'. Although it has application in other areas of tax law as well, § 269 has gained prominence for its use in disallowing the deduction of NOL carryovers." p. A-97.

In relevant part, section 269(a) provides:

> "If-
> (1) any person or persons acquire, or acquired on

> or after October 8, 1940, directly or indirectly, control of a corporation, ...
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> and the principal purpose for which such acquisition was made is evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or other allowance which such person or corporation would not otherwise enjoy, then the Secretary may disallow such deduction, credit or other allowance. For purposes of paragraphs (1) and (2), control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote or at least 50 percent of the total value of shares of all classes of stock of the corporation."

Thus, for section 269 to apply, there must be an acquisition of control of a corporation for the principal purpose of tax avoidance by securing the benefit of a deduction, credit or other allowance not otherwise available. If the purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose. Treas. Reg. § 1.269-3(a)(2). The determination of the purpose for which the acquisition was made requires scrutiny of the entire circumstances in which the transaction occurred in connection with the claimed tax result. Id.

By its terms, section 269 would seem to apply to a contingent liability shelter. The government would have to show that the most important purpose of the transactions involved was to avoid federal income tax. Again, the strength of this argument would depend upon further factual development. The facts would have to show that tax avoidance was more important than the business purpose asserted by the taxpayer. Assuming the facts as developed met this requirement, the section 269 argument would be a strong argument in the government's favor.

The Liability Assumption Should Be Treated as Money Received Under Section 357(b)(1)

The third remaining argument outlined in Notice 2001-17 is that the principal purpose of the transferee's assumption of the liability was a purpose to avoid federal income tax or was not a bona fide business purpose within the meaning of section 357(b)(1), and thus the assumption of liability should be treated as money received by the transferor that reduces its basis in the transferee stock.

I.R.C. § 357(b)(1) provides as follows:

"(1) IN GENERAL.--If, taking into consideration the nature of the liability and the circumstances in the light of which the arrangement for the assumption was made, it appears that the principal purpose of the taxpayer with respect to the assumption described in subsection (a)--

(A) was a purpose to avoid Federal income tax on the exchange, or

(B) if not such purpose, was not a bona fide business purpose,

then such assumption (in the total amount of the liability assumed pursuant to such exchange) shall, for purposes of section 351 or 361 (as the case may be), be considered as money received by the taxpayer on the exchange."

Section 357(b) provides that the total amount of liabilities assumed in a section 351 exchange will be treated as money received by the transferor if the principal purpose of the taxpayer with respect to the assumption was to avoid federal income tax or was not a bona fide business purpose. If section 357(b)(1) applies, section 358(a)(1)(A) then applies to reduce the basis in the transferee stock by the amount of the money deemed to have been received. Section 357(b)(2) provides that where the burden of proof is on the taxpayer to prove an assumption is not to be treated as money received by the taxpayer, such burden shall not be considered as sustained unless the taxpayer sustains such burden by the clear preponderance of the evidence. Treas. Reg. § 1.357-1(c) elaborates on the burden of proof by stating that the taxpayer must provide proof "by such a clear preponderance of all the evidence that the absence of a purpose to avoid Federal income tax on the exchange, or the presence of a bona fide business purpose, is unmistakable."

Once again, the strength of this argument would depend on whether the government could develop sufficient evidence to show that the principal purpose of the assumption of the contingent liabilities was to avoid federal income tax, or if not, was not a bona fide business purpose. Assuming the facts as developed met this requirement, the section 357(b) argument would be a strong argument in the government's favor.

The Loss Is Disallowed or Limited by the Loss Disallowance Rules of Section 1.1502-20, Including the Anti-avoidance Rule in Section 1.1502-20(e) and the Duplicated Loss Rule in Section 1.1502-20(c)

Where the transactions occur within an affiliated group filing a consolidated return, the Service intends to argue that the loss is disallowed or limited by the loss disallowance rules of section 1.1502-20, including the anti-avoidance rule in section 1.1502-20(e) and the duplicated loss rule in section 1.1502-20(c). This argument would not be available in [redacted] because the controlled corporation, [redacted], is not part of the [redacted] consolidated group.

The Stock Sale Loss is Not a Bona Fide Loss

The next argument the government could make is that the purported loss on the sale of the stock of the transferee corporation is not a bona fide loss actually sustained by the transferor, as required by section 1.165-1(b).

Treas. Reg. § 1.165-1(b) states:

> "To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, ... actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss."

In a contingent liability tax shelter, the taxpayer does not sustain an economic loss upon sale of the stock. Economically, the contingent liabilities transferred to the subsidiary offset nearly the entire value of the assets transferred, resulting in the relatively low fair market value of the stock received by the transferor. Thus, the fair market value of the stock represents the net value of the assets and liabilities transferred. When the stock is sold for this fair market value, there is no economic loss.

This would appear to be a strong argument for the government. It would have to be supported by appropriate factual development and expert opinion.

The Overall Transaction Lacks Sufficient Economic Substance to Be Respected for Federal Income Tax Purposes

The last argument outlined in Notice 2001-17 is that the overall transaction lacks sufficient economic substance to be respected for federal income tax purposes. In determining the tax consequences of a transaction, including whether a transaction qualifies for favorable nonrecognition treatment, the courts will look at the substance of the transaction or relationship, not merely its form. Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945). The key question in analyzing a tax-motivated transaction is "whether what was done, apart from the tax motive, was the thing the statute intended." Gregory v. Helvering, 293 U.S. 465, 469 (1935). In Gregory, the Supreme Court disregarded the potential tax consequences of a corporate reorganization despite the fact that the taxpayer had complied with all statutory requirements because the transaction had no valid business purpose and on its face lay outside the intent of the statute.

In ACM Partnership v. Commissioner, 157 F.3d 231 (3d Cir. 1998), cert. denied, 526 U.S. 1017 (1999), the Third Circuit stated the economic substance test as follows:

> "The inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them. Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990); accord Lerman, 939 F.2d at 53-54 (noting that sham transaction has been defined as a transaction that 'has no business purpose or economic effect other than the creation of tax deductions' and holding that taxpayer was not entitled 'to claim "losses" when none in fact were sustained'). However, these distinct aspects of the economic sham inquiry do not constitute discrete prongs of a 'rigid two-step analysis,' but rather represent related factors both of which inform the analysis of whether the transaction had sufficient substance, apart from its tax consequences, to be respected for tax purposes. Casebeer, 909 F.2d at 1363; accord James v. Commissioner, 899 F.2d 905, 908-09 (10th Cir. 1990); Rose v. Commissioner, 868 F.2d 851, 854 (6th Cir. 1989)." ACM Partnership, supra, 157 F.3d at 247.

For this argument to prevail, the government would have to develop sufficient facts to show that the contingent liability shelter had no practical economic effects other than the creation of income tax losses and that it was not intended to serve any useful non-tax purpose and was not reasonably expected to generate a pre-tax profit. Id. at 248, 253. The government would have to show that the taxpayer's stated business purpose of isolating the [redacted] remediation activities in a separate company for increased efficiency was not valid. There could be difficulties in developing evidence sufficiently convincing to meet this objective. Moreover, there could be litigation hazards in convincing a court of the merits of this argument. Recent appellate decisions have found economic substance in transactions where other courts have found none. IES Industries, Inc. v. United States, 253 F.3d 350 (8th Cir. 2001); UPS of America, Inc. v. Commissioner, 254 F.3d 1014 (11th Cir. 2001).

CONCLUSION

As can be seen from the foregoing discussion, the stronger arguments the Service has put forward regarding contingent liability shelters mostly depend on the development of facts showing that the taxpayer's principal motive in engaging in the transaction was tax avoidance. Although we suspect that the principal purpose of this transaction was tax avoidance, the case outcome would turn on whether the Service could develop sufficient facts to show that the taxpayer's stated business reason for the assumption of liabilities is not genuine. Given that most of the necessary information is under the taxpayer's control, one can anticipate difficulties in factual development and thus potential litigation hazards. There are also litigation hazards inherent in testing the Service's proposed arguments against this shelter before a court. We think that the litigation hazards concerning this shelter are of sufficient magnitude to make the taxpayer's global settlement offer an equitable settlement for the government.

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